Internal Audit Practice in Malaysian Public Sector Organizations

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Abstract—this descriptive paper provides an overview of the Malaysian public sector structure and the internal audit in its organization. Malaysian public sector is unique in terms of its governmental system which is a combination of federalism, democracy and monarchy. The structure of public sector organization in Malaysia comprises of several level and types of organizations which lead to the complexity of the structure thus requires a comprehensive procedure and guidelines especially in financial management. Internal audit practice in Malaysia has evolved since 1970 and its role is expanding through the requirement and instruction from Treasury Malaysia. Nevertheless, there are still a lot of issues concerning internal audit function and its effectiveness arises in Malaysian public sector. Comprehensive studies on this matter are highly recommended.

Keywords—audit; internal audit; government; public sector;

1. INTRODUCTION

Public sector can be defined as all organizations which are not privately owned and operated, but which are created, managed and finance by the government on behalf of the public. Another definition of public sector is a political organization set up with the power to direct, regulate and control the citizen's activities to enable them to live together harmoniously and constructively, and to solve their common problems more energetically and effectively. Public sector contribution is very important in term of country development. Besides work under a strict governmental constitution, regulations, procedures and budget they need to play their traditional roles and at the same time achieve their ultimate goal; fulfill the legality and discharge their accountability. The government can be classified based on their economy, their ability to provide free goods and services, political view, the way they run the government, or by election. A Government can be formed as federalism, confederation or unitary as well as adopting various governmental systems such as democracy, autocracy or monarchy. Different system adopted or different forms of government could affect the way the Government operate and the development of that particular country. Federal System is the union of the same shape that consists of a number of semi-states or self-administered regions united by a Central Government. A democratic government rules within limits sets by constitutional law and citizens' rights. The opposition parties are allowed to function freely before and after elections. The democratic government is based on fundamental principal of political equality. Malaysia practice a representative democracy, specifically, parliamentary system. A monarchy is in which the government sovereignty is actually or nominally embodied in a single individual. Forms of monarchy differ widely based on the level of legal autonomy the monarch holds in governance, the method of selection of the monarch, and any predetermined limits on the length of their period [1].

2. An Overview of Malaysian Public Sector

A. Government Form, Structure and System

Malaysian government system is unique as compared with other federal system around the world. Malaysia employs federalism form, democratic and monarchy system of government and practiced the concept of separation power. Federalism form of Malaysian government shows three different levels of government i.e. the Federal Governments, the State Governments and the Local Governments. The first two level of the governments enjoy the power in making laws and policies, while the third level only enjoy the autonomy power in terms of financial and management decision making. The Government of Malaysia refers to the Federal Government or National Government authority which has its base in the federal territories of Kuala Lumpur. The federal executive of the Government of Malaysia is located in Putrajaya. Malaysia is a federation of 13 states operating within a constitutional monarchy under the Westminster of parliamentary system and is categorized as a representative parliamentary democracy. The Constitution underlines the separation of governing powers among three different branches, namely; Legislative, Executive and Judicial. Federal legislative power is vested in Federal Parliament and the 13 State, while executive power is exercised by the Federal Government and 13 State Governments. Judicial power is exercised by the Courts established by the Federal Government. The State Governments in Malaysia also have their own respective executive and legislative branches. The judicial system in Malaysia is a federalized court system operating uniformly throughout the country. Segregation of duties of the government enhances the effectiveness and efficiency of the empowerment. The divisions in the system enable the power of control to be distributed in the hierarchy and management can be carried out more systematically [1]. General structure of Malaysian public sector is shown in Figure 1. As per April 2016, there are total of 475 entities comprise of 24 ministries, 127 federal statutory bodies, 13 state governments, 162 state stautory bodies and 149 local authorities (unpublished data recorded by local researcher).

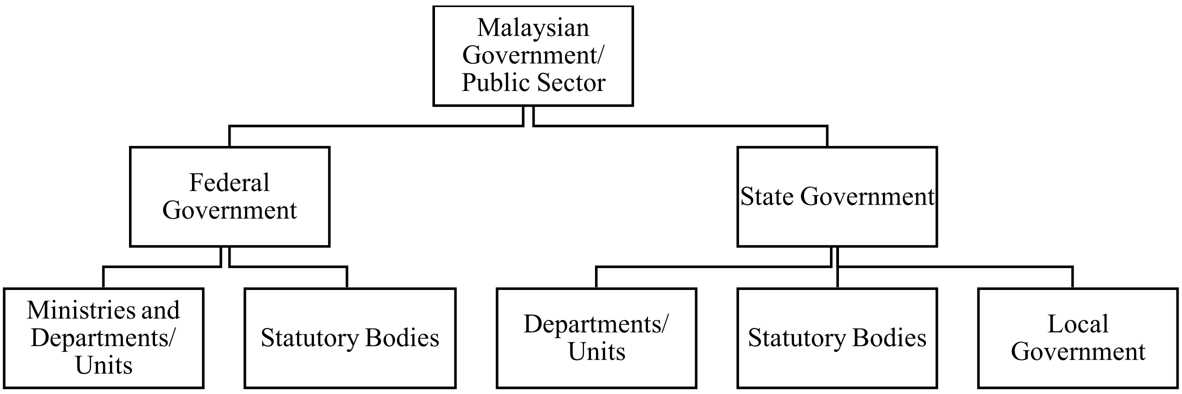

Figure 1: General structure of public sector in Malaysia

B. Financial Management of Malaysian Government

In relation to planning and control on the financial management matters, Malaysian government has set up several level of management mechanism. The main purpose is to provide an efficient and effective mechanism to ensure the public resources can be used and manage properly and objective being achieved. Basically management mechanism can be divided into three broad levels, pre-implementation i.e. policy maker, implementation level and post implementation. Policy level refers to the management mechanism at the parliament (legislature) where all the policy regarding the financial management is set-up through budget (annual appropriations). Management mechanism at implementation level refers to the mechanism at the ministries, departments and agencies. At this level, every public officer of any rank who has dealings with public moneys or stores by the definition under the section 3 of Financial Procedure Act, 1957 is an "accounting officer". All accounting officers are required to comply with financial and accounting procedures prescribed by the Federal Treasury and are held accountable for their actions. Post level refers to management mechanism at Auditor General Office (NAD) and other watchdog agencies like Malaysian Anti-Corruption Commission (MACC), Malaysian Institute of Integrity (MII). Financial management activities in Malaysian public sector comprises of such several activities such as budgeting, accounting and reporting, auditing, and performance management apart from core activities that is revenue generating and expenditure incurring. The matters regarding the financial management are stated in the constitution under the part VII: Financial Provisions. This provision comprises of 17 articles; these include the budgeting activities, financial accounting activities, reporting and auditing. Budgeting activities is related with the estimation of revenues be generated by the government for that particular year and the estimated expenditures will be spend for that year. Financial accounting activities deals with recognizing and recording all the expenditure allocations to all government agencies and the actual revenues and expenditure based on the code and object of the accounts for each of the government agencies. Financial reporting activities deals with the preparation of a financial statements comprises of balance sheet, income and expenditure statement, notes to be accounts and the statement of memorandum accounts. While the last activity is auditing, where the auditor need to audit all the financial report and record of the government agency together with the performance audit to discharge the financial accountability entrusted to each level of government organization's and officers [1].

Legal provisions in Malaysian public sector financial managements comprises of laws made by the legislative authority, regulations and accounting standards. The laws include the Federal Constitution, Acts, Enactments and as well as Ordinance. There are a number of laws related to the public financial management in Malaysia. They are Federal Constitution (FC) 1957; Financial Procedure Act (FPA), 1957; Audit Act (AA), 1956; Local Government Act (LGA), 1976 and Statutory Bodies Act (SBA), 1980. On the other hand, regulations are any rules that are approved by the ministries and administrative. Regulations include Treasury Instruction (TI), Federal Treasury Circular (FTC) and Treasury Circular Letter (TCL). Whereas, Accounting Standards are any effective accounting standards proposed and approved by regulated professional bodies. Examples of accounting standards are International Financial Reporting Standards (IFRS), Malaysian Financial Reporting Standards (MFRS), Government Accounting Standards (*Piawaian Perakaunan Kerajaan* - PPK), Public Sector Accounting Standards (IPSAS) and Malaysian Public Sector Accounting Standards (MPSAS) [1]. Hierarchy of legal provisions related to the financial requirements in the public sector is shown in Figure 2.

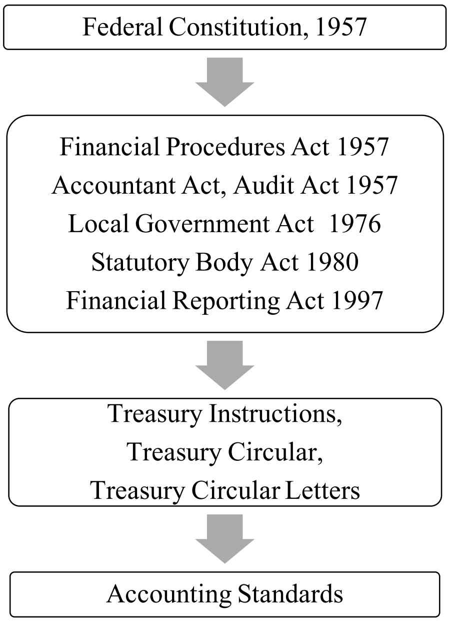

Figure 2: Hierarchy of legal provisions in financial management of Malaysian public sector organizations.

Federal Constitution (FC) is the supreme source of law and legality in Malaysia. It is the most important law that outlines the important provisions relating to the public financial management. The main provisions regarding the financial management requirements stated in the FC are as follows; Procedure to collect revenues (Article 96), Consolidated Fund (Article 97), Financial reporting and budgeting (Article 99), Withdrawal of the public money (Article 98, 100, 101, 103, 104), Auditing (Article 105, 106, 107), Responsibilities to the State Governments (Article 108, 109, 110) and Power to make borrowing (Article 111, 112). Public money will be disbursed according to the approved budget and spent accordingly. Then, the Federal Government so far as is practicable, needs to prepare and submit to the Parliament statements of assets and liabilities of the federal of last financial year (Article 99). The annual financial statements of the consolidated funds will also need to be audited by the Auditor General. Articles 105 to 107 of the Federal Constitution are related to the Auditor General. They cover three important aspects namely: the power to appoint the Auditor General, powers and duties of the Auditor General and the Auditor General reports. Audit Acts (AA) 1957 is an act to make provision for the audit of accounts of the Federation, of the States, and of certain other authorities and specified bodies as are subject to Audit by the Auditor General. The main purpose of AA is to detail out the audit requirements and procedures outlined under the Articles 105 to 107 of the Federal Constitution. The AA provides guidance for the appointment, remuneration, power and duties of the Auditor General, as well as reports need to be prepared and submitted. AA comprises of 10 sections and two schedules which provide a detailed requirement relating to auditing in the public sector. However, AA does not cover the implementation of audit by the auditors. There are specific guidelines provided by the Auditor General Office (NAD), namely the Audit Standards and Auditor General Circulars. Local Government Act (LGA) 1976 is an act to revise and consolidate the laws relating to local government in the Peninsular Malaysia. LGA comprises of several parts including Part V (General Financial Provisions) and Part VI (Accounts and Audit). Statutory Bodies Act (SBA) 1980 or act 280 is an act to provide for certain time limits in

relation to the preparation and submission of the statements of accounts for audit of all the statutory bodies incorporated pursuant to the provisions of the federal law and the audit of such accounts, the preparation and submission of the annual reports of the activities of all such statutory bodies. Part III of SBA outlines the requirements related to Audit of Accounts [1].
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3. Internal Auditing In Malaysian Public Sector Organizations

The Institute of Internal Auditor (IIA) developed the globally accepted Definition of Internal Auditing: "Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations". It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes". Internal auditing is a global profession and is practiced in both the public and private sector. As such, it is performed in various environments and within organizations that differ in purpose, size, and structure. Further, law and customs vary around the world. Such differences impact on the practice of internal auditing. In determining the most appropriate internal audit activity for an organization in the public sector, it is important to consider the influence that corporate governance structures, risk management, and control frameworks have on the ability to implement internal auditing and develop necessary internal audit capabilities. The reality that management capacity, infrastructure, and governance arrangements are different in developed and developing countries must also be considered [2].

A.Evolution of Internal Auditing

Internal auditing dates from ancient times in the years 1900 to 1950. However, it was not until the late thirties and early forties that it became widely utilized. Brinks (1941) published the first significant text on internal auditing. This publication served as a catalyst to bring together in that same year the twenty-four founders of the Institute of Internal Auditors (Cadmus, 1960). The Institute and the profession grew rapidly due, to a great extent, to the pressing needs of World War II. It was also during this period that internal auditors began to be more concerned with more than a financial audit. Large organizations began to realize that the internal auditors can perform a greater service than just looking for accounting errors. Thus, internal auditors began to change to new concepts of auditing and focus upon improving operations rather than just scouting for accounting errors. This new concept of auditing received management acceptance because the recommendations made by internal auditors were more helpful than those typically provided by external auditors; and, significantly, because findings remained internal and were not made public. Internal auditors adopted the term "operations" or "operational" auditing to describe their new improved service. This term came to the attention of internal auditors in an article by Kent (1948). Basically, operational auditing uses an inductive approach in that it drew from accounting documents recommendations for change that is it moved from the specific or actual to the ideal. Internal auditors thus pioneered the concept of operational auditing. However, during this same period a similar concept, called management auditing, was developed in the literature of management. It is believed that Rose (1932) first coined the term "management audit". He wrote and published this book of the same name in London. Rose's audit was basically designed to analyze the functional activities of a company and had been previously developed for policyholder companies. Benedict's (1948) followed Rose's work and his system offers to evaluate management by means of weighted factorial analysis. Both writings by Rose (1932) and Benedict (1948) represent the earliest attempts to develop an interview type management audit. The management audit was organized around the functions of management and followed a deductive approach as opposed to the inductive approach of operational auditing. These two similar but separate concepts were the forerunners of today's movement towards the extension of the scope of auditing. Management auditing and operational auditing began to merge in the late 1950s and early 1960s. Internal auditors frequently referred to their audit as management audit, and many writers stated that the terms were synonymous. At present, both terms refer to an audit that goes beyond traditional attestation into the area of managerial economy, efficiency and effectiveness. Internal audit activities are performed in diverse legal and cultural environments; within organizations that vary in purpose, size, and structures; and by persons within or outside the organization (Sawyer, 1993). These differences may affect the practice of internal auditing in each environment. However, compliance with International Standards for the Professional Practice of Internal Auditing (Standards) is essential if the responsibilities of internal auditors are to be met [3].

B. Internal Audit in Malaysian Public Sector Organizations

Generally, audit practice in Malaysia can be divided into two categories i.e. internal and external auditing. External auditing is carried out by National Audit Department (NAD) under Auditor General as stated in Audit Acts 1957. For the last three decades, auditor general has been lobbying for the establishment of effective internal audits to ensure that independent appraisal functions exist within each organization to assist controlling officers' discharge their duties effectively. Although the Treasury is responsible for the overall policy of developing internal audit functions in agencies, training internal auditors and issuing standards and guidelines for their compliance, the internal auditors are responsible directly to the controlling officers. Internal audit reports are made directly to the controlling officers but are also made available for scrutiny by the NAD. The staffs are from various disciplines and the senior posts are filled by civil servants and seconded officers from the NAD and the Accountant General's Department. NAD also has no direct responsibility for monitoring the performance of the budget, the physical progress of projects or of the existing management information systems. The NAD would in the discharge of its duties only report on deficiencies in budget implementation, improper payments and authorization, inadequate or poor record keeping and weak systems and controls. Monitoring of information and achievement of plan objectives are the responsibilities of controlling officers and the central agencies [1].

Historically, the development of internal auditing in the Malaysian public sector expanded in 1970 when the Ministry of Defense set up its internal audit department. However, the scope is limited to financial audit [4]. Malaysian government first released Treasury Circular No.2 in year 1979 to mandate the audit practices and provide guidelines at Federal government level. This circular detailed the roles and responsibilities of an internal audit function, types of audit and the scope of audit to conduct. The implementation scope of Internal Audit practice was extended to replace the Treasury Circular No.2 year 1979 with Treasury Circular No. 9 year 2004. This circular extended the formation of Internal Audit function at all Ministry, Department and State Government level. However, this requirement excludes the state agencies, local authorities and state economic development corporations. In 2011, review and consolidation for all circulars were mandated under 1 Treasury Circular (1PP – 1 *Pekeliling Perbendaharaan*). Apart of the 1PP, two main sections were outlined to describe the duties and establishment of Internal Audit function which are the PS 3.1/2013 and PS 3.2/2013. Treasury Circular PS 3.1/2013 outlines the roles and responsibilities of the Internal Audit unit, Ministry Secretary or Head of Federal Department or State Secretary and the Treasury of Malaysia. This circular also details the commands of internal audit duties. Treasury Circular PS 3.2/2013 explains the requirements and responsibilities of the Audit Committee at both federal ministry and state government level [5].

According to the Treasury Circular PS 3.1/2013, establishment of internal audit function is under responsibility of Secretary General of the Ministry / Head of Federal Department / State Secretary. For all departments without internal audit function, the internal audit activity must be conducted by the internal audit function of the ministry that governs the respective departments. At State level, this internal audit function is referred to the endorsed internal audit function under purview of State Secretariat Office. The internal audit function is defined as an independence function, with the purpose of assisting the organization to achieve its objective through systematic and disciplined approach to evaluate and determine the effectiveness of process control and governance. The role of internal audit function is conducting financial management audit which include financial system, internal control, and financial record to assure that any expenditures, income, assets and store are according to the laws, rules and instructions stipulated by the authorities. Performance audit is also one of the responsibilities of internal audit function. Treasury Malaysia is a central agency that holds responsibility to monitor and coordinate the establishment of internal audit function in ministries or federal departments and state secretariat office. Basically, the role and responsibility of internal audit function is different from National Audit Department (NAD) which acts as external audit. The authority and responsibility of NAD is stated in constitution while the responsibility of internal audit function is stated administratively. Nevertheless, both play the crucial role with the same objectives that is to improve the effectiveness of governance process, financial management and accountability in public administrative. The cooperation and good relationship between both parties are important to achieve the objectives [6].

4. Issues and Concerns

The importance of internal auditing in the public sector has been highlighted by the Malaysian Auditor General in The Star Newspaper (May, 2007). According to the Auditor General, internal audit function plays a proactive role as a monitoring mechanism and in examining ongoing projects. It can assist public sector entities in achieving their objectives effectively, efficiently, economically and ethically by providing unbiased and objective assessments. Internal auditors' unbiased findings and recommendations represent critical input to good governance that can lead organizations to take prompt and appropriate corrective actions to remedy identified weaknesses and deficiencies. An effective internal audit function will add value and improve the organization's operation Despite the efforts to improve the corporate governance, the problem of corporate governance still persist in Malaysia and this triggers the question of what factors contributing to internal audit effectiveness? There are very few studies examining internal audit function in Malaysian public sector organizations [7]. It is believed that the first study was conducted by the Malaysian Institute of Accountants (MIA) in June 1988 (MIA, 1989) and another comprehensive study was published in 2007 by Ali et al. (2007) where in-depth interviews with internal auditors from 35 states and local government bodies located in Peninsular Malaysia revealed that audit function in Malaysian state and local governments faces numerous such as lack of staff (resources), inadequate auditing skills and training shortages which obstruct the auditors in performing their duties [8].

Auditor General's Office (2013) highlighted the inefficiencies of the Internal Audit in its annual audit reports. Five main weaknesses were highlighted in the report of Auditor General's audit i.e. improper payment, low quality of finished jobs, work or supplies performed not according to specifications, unreasonable delays, and weaknesses in management of products and assets after they have audited seven projects and activities by government statutory bodies which are quite similar weaknesses as previous years. Additional weaknesses highlighted in the report includes wastage, weaknesses in revenue management, weaknesses in management of the Governments assets, failure to comply with environmental laws and weaknesses in management of government's companies [9]. Reference [10] reported that the overall performance of financial management at Ministries level was declining. Only 20 ministries were reported to achieve "excellence" performance as compared to 23 ministries in 2013 and 22 ministries in 2012. The surprise inspections of 244 departments showed that only 24.6% of the departments audited are fully complied with the regulations and procedures while 75.4% are not complying with all requirements. Almost 50 elements of weaknesses or non-compliance with regulations and procedures were reported in relation with the management of public money and assets. Generally, these weaknesses include work/procurement/service did not meet the specifications/non-quality/unsuitable; unreasonable delays; improper payment and wastages. In the most recent Auditor General Report, the same things were reported. Audit findings showed that the overall performance of the ministries had declined as compared to previous years. In 2015, only 16 ministries were rated as excellence. Surprise inspections of 226 federal departments at state and district level disclosed that most of them did not fully comply with stipulated regulations. These include issues with improper management of mail registers, cash books and petty cash book; relevant officer in charged for safety box were not having the authority and inspections were not conducted as required. As in previous years, the same weaknesses were reported [11]. In the same report, the NAD has highlighted that:

> "Ministries/Departments should enhance the effectiveness of internal audit. Among others, they should ensure that internal auditors get sufficient training and guidance, prepare the annual audit plan so that auditing could be carried out according to priorities, evaluate objectively and independently not only on internal controls but also on risk management and organizational governance, report on significant findings as well as giving recommendations that give impact and outcome to the organization," (National Audit Department, Putrajaya, April 27, 2016).

The issues reported in the Auditor General Report seems to be repeating every year which resulting in the loss of billions of Ringgit Malaysia of public money. Thus, a series of interview sessions have been conducted by the team of researchers for more understanding on the focus of research i.e. internal audit effectiveness of the Malaysian public sector organizations. According to the officer from the National Audit Department, there is very lack of research conducted in this area, thus, there is limited references available for the practitioners. Even though the Ministry of Finance has conducted regular check up on the performance of internal audit unit in ministries' departments, yet, the monitoring of the internal audit functions in states are only conducted in three years cycle. In another interview with the Head of Internal Audit Unit of State Secretary Office, it is figured out that most of the states' departments do not have their own internal audit functions regardless of the requirement stated in the Treasury Circular PS 3.1/2013 where the departments should have their own internal audit function. Most of the reasons may be due to the lack of availability of qualified internal audit staff and lack of financial capability of the departments. Therefore, these departments are under purview of the Internal Audit Unit in the State Secretary Office. Same issues arise since there is lack of competent staff in the unit. Therefore, the audit activities are regularly conducted in departments with high risk profiling while other state departments with medium or low risk profiling are conducted on cycle or upon request by the State Secretary.

Moreover, the interview conducted in one of the State Statutory Bodies has highlighted that the internal audit unit also plays another role which is integrity unit. The establishment of integrity unit is governed by the Prime Minister Directive No. 1 2014. However, due to several reasons such as budget constraint, the instruction given by this respective State Secretary Office give mandate to the internal audit unit to carry out another function i.e. integrity officer. This double workload is challenging according to the interviewee since there are also several other functions that he/she need to carry out as the Head of Internal Audit Unit. Hence, it may be one of the reasons that may obstruct the effectiveness of internal audit functions in Malaysian public sector organizations. This also brings the question as to what else has led to the weaknesses highlighted in the Auditor General Report of Malaysian public sector. Yet, there has no specific tool that enables the internal audit unit to rate their performance or effectiveness level.

In 2009, the Institute of Internal Audit (IIA) Research Foundation United States has developed a matrix of Internal Audit Capability Model (IA-CM) where internal audit unit can rate their capability level of six dimensions that lead to internal audit effectiveness. These dimensions include services and role of internal audit, people management, professional practices, performance management and accountability, organizational relationships and culture as well as governance structures. IA-CM explains the evolutionary path to be followed by the public sector organization for development of effective internal audit. It shows the progressing steps to be undertaken from the initial level to the optimizing level of each dimension [2]. At the moment, there has no particular research conducted using IA-CM for evaluating internal audit function in Malaysian public sector organizations especially in state and local governments.

In order to gain comprehensive view of the capability level of internal audit functions in Malaysian public sector organizations, it is highly recommended by the practitioners and top government officers to conduct more research related to this study. Consequently, it will ensure accountability and integrity of the management of the public fund while improving the performance of Malaysian public sector organizations through the effectiveness of internal audit functions.

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